November 2016

EMIR: are you ready for margining?

Looming large on the horizon is another significant piece of the EMIR jigsaw – the requirement for counterparties to provide margin in respect of OTC derivatives transactions that are *not* cleared by a central counterparty. This will start, subject to some phased implementation, in just over three months' time, on **1 March 2017**.

BACKGROUND

This has been a long time coming. A range of risk mitigation requirements in respect of OTC derivatives transactions that are not centrally cleared have applied since September 2013. However, one important component of those risk mitigation techniques – the requirement for there to be a bilateral exchange of collateral between counterparties – was delayed pending agreement of international standards in this area by BCBS and IOSCO.

The European Supervisory Authorities (ESMA, EBA and EIOPA) (**ESAs**) published draft Regulatory Technical Standards (**RTS**) in March 2016. On 4 October 2016 the European Commission adopted an amended delegated regulation setting out the final RTS[1]. Following recent announcements from the European Parliament and European Council, it is now highly likely that the delegated regulation will enter into force in January 2017.

WHO IS SUBJECT TO THE MARGIN REQUIREMENTS UNDER THE RTS?

Potentially, *any* counterparty to non-centrally cleared OTC derivatives transactions which is subject to Regulation (EU) No. 648/2012 (**EMIR**) (although available exemptions may serve to narrow that scope – see below).

It is clear that "financial counterparties" (**FCs**) as defined under EMIR will be within scope: i.e. credit institutions, MiFID investment firms, UCITS and their management companies, AIFs managed by authorised or registered AIFMs, insurers/reinsurers and institutions for occupational retirement provision (e.g. most occupational pension schemes).

[1] The final RTS is available *here* and the annexes to the RTS are available *here*.

Non-financial counterparties (**NFC**) above the specified "clearing threshold" (**NFC+**) will also be within scope. The requirements could apply in respect of a non-financial counterparty below the specified "clearing threshold" (**NFC-**) at its option.

THE HEADLINES

- *Variation margin start date:* the requirement to exchange collateral as variation margin in accordance with the RTS will apply: (i) one month after entry into force of the RTS to any counterparty with an outstanding aggregate average notional amount of non-centrally cleared OTC derivatives transactions above EUR 3 trillion; and (ii) from **1 March 2017** to other counterparties, in respect of all non-centrally cleared OTC derivatives transactions entered into on or after that date;

- *Initial margin start date:* there will be phased implementation starting one month after entry into force of the RTS (for any counterparty with an outstanding aggregate average notional amount of non-centrally cleared OTC derivatives transactions above EUR 3 trillion) and thereafter on an annual basis from 1 September 2017 until 1 September 2020 (on a sliding scale). Depending on the outstanding aggregate average notional amount of non-centrally cleared OTC derivatives transactions entered into by the relevant counterparty, it may not ever be necessary to provide initial margin – but it will be necessary in any event to undertake the calculations in order to determine and adduce evidence of this;

- *Exchange of Collateral Agreements* (**ECAs**): the RTS require counterparties to enter into ECAs. While existing ISDA documentation – including Credit Support Annexes (**CSAs**) – already contemplate the exchange of collateral, amendments (or new documentation) will be necessary in order to comply with the RTS. These amendments need to be agreed in short order;

- *Procedures and policies:* in addition to (and to facilitate) the above, every counterparty will be required to have:

  - **risk management procedures** addressing, amongst other things, eligibility of collateral, the calculation and collection of collateral, the management and segregation of collateral and the calculation of the adjusted value of collateral; and

  - a **policy** to assess on a continuous basis the enforceability of the netting and exchange of collateral arrangements it enters into.

THE DETAIL

WHAT IS THE DIFFERENCE BETWEEN INITIAL MARGIN AND VARIATION MARGIN?

Variation margin means the collateral collected by a counterparty to reduce its effective exposure to its counterparty by reference to the mark-to-market or mark-to-model value of any outstanding non-centrally cleared OTC derivatives transactions to zero. The aim of variation margin is to protect counterparties against exposures related to fluctuations in the mark-to-market or mark-to-model value of their OTC derivatives transactions.

Initial margin means the collateral collected by a counterparty to cover its current and potential future exposure in the interval between the last collection of collateral and the liquidation of positions or hedging of market risk following a default of the other counterparty.

While the two types of margin appear similar, there are significant differences:

- the amount of collateral required as variation margin will fluctuate according to the mark-to-market or mark-to-model value of the underlying OTC derivatives transactions. In contrast, the amount of initial margin will be based on the risk position of a counterparty and market conditions, calculated using either a standardised method or a bespoke model (the latter complying with parameters set out in the RTS);

- the amount of collateral to be collected as variation margin must be calculated on a *daily* basis. In contrast, the amount of initial margin to be collected must be calculated following the occurrence of certain events (such as a payment or delivery other than a margin transfer) or, if no such events have occurred, every 10 business days;
- unlike variation margin, initial margin amounts may *not* be offset against each other; and
- the RTS require initial margin to be held on a segregated basis, ring-fenced from the assets of the counterparty collecting the collateral, so as to avoid the counterparty providing the collateral from taking additional credit risk on the counterparty collecting the collateral.

WHAT DO THE RTS REQUIRE?

At the highest level, the RTS prescribe the requirements on counterparties to have risk management procedures for the exchange of collateral as margin in respect of those OTC derivatives transactions they enter into with one another *which are not cleared through a central counterparty* (**CCP**).

Those **risk management procedures** must include procedures providing for or specifying the following (where applicable, in accordance with any requirements in the RTS):

- the eligibility of collateral;
- the calculation and collection of collateral (i.e. initial margin and variation margin);
- the management and segregation of collateral;
- the calculation of the adjusted value of collateral;
- the exchange of information between counterparties;
- the authorisation and recording of any exceptions to the risk management procedures, and the reporting of those exceptions to senior management;
- the terms of all necessary agreements (including the terms of the netting agreement and the terms of the ECA);
- the periodic verification of the liquidity of the collateral to be exchanged;
- the timely re-appropriation of collateral by the counterparty providing the collateral from the counterparty collecting the collateral if there is an event of default;
- the regular monitoring of exposures arising from intra-group OTC derivatives transactions and the timely settlement of the obligations resulting from those transactions.

These risk management procedures must be tested, reviewed and updated as necessary, and at least annually.

A counterparty must also establish a **policy** to assess on a continuous basis the enforceability of the netting and exchange of collateral arrangements it enters into and must obtain an independent legal review of enforceability.

REMINDER: WHAT IS AN NFC+?

An NFC is an undertaking established in the EU which is not an FC (note that this will include an AIF that is not currently managed by an authorised or registered AIFM, for instance one that is marketed in the EU under a national private placement regime).

An NFC+ is an NFC whose gross notional value of OTC derivatives transactions which are not objectively measureable as reducing risks directly relating to the commercial activity or treasury financing activity of the NFC or its group (as defined in EMIR) is above a prescribed "clearing threshold" for certain asset classes (calculated on a rolling average basis over 30 working days). The thresholds are high, but if one threshold is crossed for one asset class, the NFC becomes an NFC+ for all asset classes even if none of the other thresholds is crossed:

"CLEARING THRESHOLDS" FOR DETERMINING WHETHER AN NFC IS AN NFC+	
ASSET CLASS	**THRESHOLD**
OTC credit derivatives	EUR 1 billion
OTC equity derivatives	EUR 1 billion
OTC interest rate derivatives	EUR 3 billion
OTC foreign exchange derivatives	EUR 3 billion
Other OTC derivatives combined	EUR 3 billion

WHEN WILL THE MARGIN REQUIREMENTS APPLY?

The general rule is that only new OTC derivatives transactions (i.e. transactions entered into on or after the relevant application date(s) mentioned below) will be affected by the RTS.

For most counterparties the requirement to exchange collateral as ***variation margin*** in accordance with the RTS will come into force on **1 March 2017**.

The date from which the ***initial margin*** requirements apply depends on the outstanding aggregate average notional amount of non-centrally cleared OTC derivatives transactions of that counterparty. The table below summarises the position:

<table>
<tr><th colspan="3">EMIR MARGIN APPLICATION DATES, REQUIREMENTS</th></tr>
<tr><th>OUTSTANDING AGGREGATE AVERAGE NOTIONAL AMOUNT OF NON-CENTRALLY CLEARED OTC DERIVATIVES TRANSACTIONS</th><th>INITIAL MARGIN APPLICATION DATE</th><th>VARIATION MARGIN APPLICATION DATE</th></tr>
<tr><td>Both counterparties (or their groups) – each above EUR 3 trillion</td><td>One month after entry into force of RTS</td><td>One month after entry into force of RTS</td></tr>
<tr><td>Both counterparties (or their groups) – each above EUR 2.25 trillion</td><td>1 September 2017</td><td rowspan="5">1 March 2017*</td></tr>
<tr><td>Both counterparties (or their groups) – each above EUR 1.5 trillion</td><td>1 September 2018</td></tr>
<tr><td>Both counterparties (or their groups) – each above EUR 750 billion</td><td>1 September 2019</td></tr>
<tr><td>Both counterparties (or their groups) – each above EUR 8 billion</td><td>1 September 2020</td></tr>
<tr><td>Either counterparty (or its group) - EUR 8 billion or below</td><td>IM DOES NOT APPLY</td></tr>
<tr><td colspan="3"><u>Notes:</u>

The above thresholds should be assessed individually with respect to each counterparty to an OTC derivatives transaction and (where applicable) its relevant group – see below for further details on how to do this calculation.
This table does not reflect specific rules which apply in relation to certain FX OTC derivatives transactions, single-stock equity options and index options, and certain derivatives transactions concluded between EU counterparties and non-EU counterparties forming part of the same consolidation group – different dates apply to these.

* If the RTS do not enter into force until after 1 February 2017, the date of application of the variation margin requirements will be pushed back to the date 1 month following that entry into force.</td></tr>
</table>

For **physically-settled FX forwards**, the variation margin requirements will take effect from the earlier of **31 December 2018, or the date on which a common, EU-wide, definition for physically-settled FX forwards is introduced** (being the date on which the relevant Commission Delegated Act referred to in Article 4(2) of Directive 2014/65/EU (MiFID II), specifying some technical elements of certain MiFID II definitions, comes into force).

For single-stock equity options or index options, the initial and variation margin requirements will apply from **3 years** after the date the RTS enter into force.

Certain FX OTC derivatives transactions are exempt from initial margin requirements altogether.

HOW DO YOU CALCULATE THE OUTSTANDING AGGREGATE AVERAGE NOTIONAL AMOUNT OF NON-CENTRALLY CLEARED OTC DERIVATIVES TRANSACTIONS (IN ORDER TO DETERMINE THE START DATE FOR THE MARGIN REQUIREMENTS)?

For the purpose of determining the date from which the requirement to provide margin will apply to a particular counterparty, a figure must be derived by taking the average of the total outstanding gross notional amount of non-centrally cleared OTC derivatives transactions as recorded on the **last business day of March, April and May in each year** with respect to the counterparty (or its group). The first year's calculation must be performed in relation to the last business day of March, April and May ***2016***.

Subject to the qualification in relation to funds (see below), the calculation must include:

- all entities within the relevant counterparty's group (as defined in EMIR);
- all non-centrally cleared OTC derivatives transactions of that group;
- all intra-group non-centrally cleared OTC derivatives transactions of the group (counting each of those contracts only once).

As regards authorised UCITS and AIFs managed by authorised or registered AIFMs, each fund should be considered as a distinct entity and treated separately (and therefore not grouped) provided that:

- the funds are distinct segregated pools of assets for the purposes of the fund's insolvency or bankruptcy; and
- the segregated pools of assets are not collateralised, guaranteed or otherwise financially supported by other investment funds or their managers.

ARE THERE ANY EXEMPTIONS?

Yes, there are a number of *optional* exemptions from certain of the margin requirements.

It should be noted that *all* of the exemptions are optional; so, it should not be assumed that your counterparty will necessarily seek to invoke them. For example, while an AIF that is managed by an AIFM that is not currently authorised or registered may be categorised as an NFC- (i.e. where none of the above "clearing thresholds" have been exceeded), or would be an NFC- if it were established in the EU, the investment bank counterparty (FC) may require margining in accordance with the RTS as a matter of course, as part of its risk management procedures.

The exemptions include the following:

NFC-s

Counterparties may provide in their risk management procedures that no collateral (initial or variation margin) is exchanged in relation to non-centrally cleared OTC derivatives transactions entered into with NFC-s (i.e. those non-financial counterparties whose relevant OTC derivatives do not exceed any of the "clearing thresholds" outlined in the table at the top of page 4, above).

FX transactions

Counterparties may elect for physically-settled FX forwards, physically-settled FX swaps and currency swaps to be exempt from ***initial margin*** requirements but, despite strong lobbying on the matter, there is no such optional exemption in relation to the ***variation margin*** requirements in respect of such derivatives.

For physically-settled FX forward transactions, the variation margin requirements will take effect from the earlier of 31 December 2018 or the date on which a common, EU-wide, definition for physically-settled FX forwards is introduced (being the date on which MiFID II comes into force).

Minimum transfer amount

Counterparties may provide in their risk management procedures that no collateral (whether initial margin or variation margin) is collected from a counterparty where the amount due from the last collection of collateral is equal to or lower than a minimum transfer amount agreed by the counterparties (note that a minimum transfer amount may not exceed EUR 500,000 or its equivalent in another currency across initial margin and variation margin, with any single counterparty).

WHAT COUNTS AS ELIGIBLE COLLATERAL?

Counterparties will only be permitted to exchange collateral of an asset class set out in a list prescribed in the RTS.

It is likely that the market will mainly continue to use cash or highly-rated sovereign securities as collateral, although parties are free to choose from the wider range of assets as set out in the RTS. For example, subject to availability and assuming use of such collateral would be cost-effective, this may include corporate debt, certain equities, units in UCITS funds (subject to conditions), gold and the most senior tranche of a securitisation (as defined in the Capital Requirements Regulation (provided it is not a re-securitisation as defined in that Regulation)).

Although the RTS allow a degree of flexibility in terms of the range of permitted eligible collateral classes, there are conditions and restrictions. Specified asset classes of collateral will qualify as eligible collateral subject to meeting certain credit quality requirements as set out in the RTS. For instance, in relation to certain of the prescribed debt classes of eligible collateral, the RTS require a collecting counterparty to conduct a credit-quality assessment using (broadly) one of three methodologies: the internal ratings of the collecting counterparty, the internal ratings of the counterparty providing the collateral (where the counterparty providing the collateral is established in the EU or is subject to equivalent consolidated supervision in a third country) or a credit quality assessment issued by a recognised External Credit Assessment Institution (ECAI) as defined in the Capital Requirements Regulation. Other and additional specific requirements also apply in relation to specified classes of eligible collateral.

Detailed concentration limits apply in the case of collateral accepted by way of initial margin.

A controversial requirement relates to the 8% haircut which applies to:

- non-cash collateral provided as variation margin in currencies other than those agreed between the parties in the relevant documentation, including the ECA (note - this issue could be avoided in the drafting of the relevant ECA);

- cash collateral provided as initial margin and non-cash collateral provided as initial margin in a currency other than that specified by the parties in the relevant documentation, including the ECA, as the termination currency.

No haircut is applied in respect of cash margin provided as variation margin.

HOW SOON MUST COLLATERAL BE CALCULATED AND PROVIDED?

Counterparties must:

- calculate variation margin at least on a daily basis;
- calculate initial margin no later than the business day following one of a set of prescribed events, including where a new non-centrally cleared OTC derivatives transaction is executed or added to the netting set, where an existing non-centrally cleared OTC derivatives transaction expires or is removed from the netting set and where no calculation has been performed in the last ten business days.

The calculation of initial and variation margin must be carried out in accordance with a prescribed methodology.

Broadly, as regards the delivery of collateral, for both initial and variation margin the counterparty providing the collateral must do so on the same business day as the calculation date.

This will mean, particularly in relation to variation margin requirements, counterparties may need to maintain a "buffer" of cash or eligible non-cash collateral in order to be able to respond to daily (and possibly intra-daily) margin calls. For some counterparties, this may mean that they would need to look to bank funding lines to obtain faster access to cash to provide as variation margin.

IS IT POSSIBLE TO "RE-USE" COLLATERAL?

Subject to the terms of the relevant CSA or other ECA, collateral collected in order to satisfy the *variation margin* requirements *can* be re-used.

Parties that wish to re-use collateral collected as variation margin should bear in mind the collateral re-use provisions of Regulation (EU) 2015/2365 (the Securities Financing Transactions Regulation).

However, collateral collected in order to satisfy the *initial margin* requirement *cannot* be re-used (and this cannot be contracted out of under the relevant CSA or other ECA).

WHAT CHANGES ARE REQUIRED IN RESPECT OF ISDA (AND OTHER) DOCUMENTATION?

The required risk management procedures must include procedures providing for the terms of all necessary agreements to be entered into by counterparties – including the terms of the "netting agreement" and the terms of the ECA – before the conclusion of non-centrally cleared OTC derivatives transactions.

The ECA must include at least the following terms:

- the levels and types of collateral required;
- the segregation arrangements;
- the applicable netting set (i.e. the group of non-centrally cleared OTC derivatives transactions which are the subject of the ECA);
- the procedures for notification, confirmation and adjustment of margin calls;
- the procedures for the settlement of margin calls for each type of eligible collateral;
- the procedures, methods, timeframes and allocation of responsibilities for the calculation of margin and the valuation of collateral;
- the events considered to be events of default and termination events;

- the applicable law governing the non-centrally cleared OTC derivatives transactions;
- the law applicable to the ECA.

Counterparties which enter into OTC derivatives transactions may already be used to having to provide collateral in relation to their OTC derivatives transactions.

Accordingly, "re-papering" in preparation for the provision of *variation margin* under the RTS, at least, may not present a great challenge to the counterparties. That said, some readjustment to existing documentation will be required (for example it will no longer be possible for an uncollateralised exposure to subsist with respect to a counterparty where previously this may have been agreed by the parties as being commercially advantageous).

Furthermore, counterparties should note that if an existing CSA is amended (rather than an entirely new CSA being put in place) to be compliant with the RTS, then ***all existing transactions*** will become subject to the margin requirements as prescribed by the RTS.

Accordingly, counterparties with outstanding transactions may wish to consider whether it would be beneficial to structure their arrangements so that their existing ISDA documentation – which may not be compliant with the RTS – will continue in respect of outstanding transactions and put in place new ISDA documentation – which is compliant with the RTS – for all new OTC derivatives transactions.

Those counterparties subject to the new *initial margin* requirements may find themselves having to agree a new suite of documentation. This is because the RTS introduce stringent requirements regarding the holding of initial margin:

- non-cash collateral provided as initial margin must be protected from the default or insolvency of the defaulting counterparty by segregating it (whether on the books or records of a custodian or third party or via other legally binding arrangements);
- cash collateral provided as initial margin must be maintained in cash accounts at central banks or credit institutions fulfilling certain conditions.

For example, assuming a third party custodian is used, new custody agreements, security agreements (over the custody account(s)) and potentially account control agreements (governing the basis on which withdrawals can be made from the custody account(s)) may be required.

As part of the process of revisiting and amending existing documentation, there will be a number of commercial issues to consider:

- counterparties can agree a minimum transfer amount of no more than EUR500,000 (or its equivalent in another currency), on a counterparty-by-counterparty basis;
- counterparties can agree separate minimum transfer amounts for initial margin and variation margin, but the *aggregate* can be no more than EUR500,000 (or its equivalent in another currency);
- it will *no longer be possible to set a threshold amount* (i.e. an amount of uncollateralised exposure that the parties are prepared to allow in respect of each other before calling for collateral as margin). Once exposure exceeds the relevant minimum transfer amount, the full amount of collateral must be transferred. This may have far-reaching cost implications for certain market participants that have previously run uncollateralised exposures in order to minimise costs.

WHAT SHOULD COUNTERPARTIES BE DOING NOW?

Counterparties need to be advanced in their preparations. Steps they should now be taking include:

- determining, across the group, the total gross notional amount of non-centrally cleared OTC derivatives transactions that were outstanding on the last business day in each of March, April and May 2016 — the result of this calculation will determine whether the requirements regarding *initial margin* will apply and, if so, when;
- putting systems in place to collect data to determine the total gross notional amount of non-centrally cleared OTC derivatives transactions that are outstanding on the last business day in each of March, April and May for future years - even if initial margin will not apply from the outset and is unlikely ever to be relevant in the future (i.e. because the figure will always be below the EUR 8 billion threshold), it will still be necessary to be able to adduce evidence of the fact that the calculation has been done;
- reviewing existing arrangements and, if required, negotiating and agreeing amendments to ISDA documentation (including CSAs);
- establishing risk management procedures for the exchange of collateral in line with the RTS (or reviewing and amending existing procedures);
- considering whether it will be necessary to establish credit lines or other short-term cash funding arrangements in order to meet variation margin calls;
- conducting a cost-benefit analysis and considering the likely costs impact of the new margin requirements in relation to non-centrally cleared OTC derivatives transactions compared to the costs of centrally-cleared OTC derivatives transactions (where possible to do so);
- performing an independent legal review of the enforceability of collateral and netting arrangements and policies to assess on a continuous basis— including whether to subscribe to ISDA in order to gain access to its database of netting and enforceability opinions.

HOW WE CAN HELP

If your business is likely to be affected by the margin requirements under the RTS, or you would like to discuss any aspect of those requirements further, please contact any one of the partners below, or your usual Travers Smith contact.

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